

I. Executive Summary

This chapter provides the overall results and recommendations developed during this audit of New Jersey Natural Gas Company (NJNG) competitive services and affiliate relationships, conducted on behalf of the New Jersey Board of Public Utilities (BPU) in July, August, and September 2000.

A. Audit Objectives

The overall objective of this Competitive Services Offerings and Affiliate Standards Compliance audit is to ensure that New Jersey Natural Gas Company and/or its related competitive business segments do not have an unfair competitive advantage over other, non-affiliated purveyors of competitive services. The focus of the audit was to evaluate and review NJNG's compliance with the BPU's *Final Interim Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements (Affiliate Standards)*, which were adopted by the Board in Order EX99030182 on March 15, 2000. NJNG's Compliance Plan in response to this order was filed on June 15, 2000.

B. Report Outline

This report includes the following chapters:

- ◆ *Introduction*, including findings and recommendations relative to NJNG's compliance plan
- ◆ *Management and Organization*, including a summary discussion of the background and structure of NJNG. This chapter also includes findings and recommendations relative to NJNG's compliance with the *Affiliate Standards* pertaining to:
 - Shared officers and directors (Section 5.5 of the *Affiliate Standards*)
 - Advertising (Section 5.6)
 - Separation (Section 5)
- ◆ *Asset Transfers*, including an analysis of asset transfers over the past three years, as well as findings and recommendations relative to NJNG's compliance with the *Affiliate Standards* pertaining to asset transfers between the regulated and non-regulated entities/competitive services (Section 5.9)
- ◆ *Employee Transfers*, including an analysis of employee transfers over the past three years, as well as findings and recommendations relative to NJNG's compliance with the *Affiliate Standards* pertaining to employee transfers between the regulated and non-regulated entities/competitive services (Section 5.7)



- ◆ *Service Transactions*, including an analysis of personnel and other transactions over the past three years, including transaction-sampling analysis. This chapter also includes findings and recommendations relative to NJNG's compliance with the *Affiliate Standards* pertaining to:
 - Cost allocation (Section 6)
 - Accounting standards (Section 6.4)
 - Books and records for non-regulated entities/competitive services (Section 6.4)
- ◆ *Competitive Services Offerings and Affiliate Standards Database*, including summary reports showing each affiliate and competitive service's compliance with each *Affiliate Standard*, produced using the database tool Schumaker & Company developed to assist in this audit

C. Recommendations

The following is a detailed listing of the recommendations contained in this report.

Recommendation Number		Recommendation Statement	Page
1	Recommendation II-1	Resubmit NJNG Compliance Plan after incorporating the findings and recommendations of this report. (Refer to Finding II-1).	8
2	Recommendation III-1	Reorganize in such a manner that no individuals serve as directors or officers for both the regulated and non-regulated entities. (Refer to Finding III-1).	20
3	Recommendation III-2	Establish specific mechanisms and procedures within NJR to ensure that it complies with the Affiliate Standards for shared officers and directors. (Refer to Finding III-1).	20
4	Recommendation III-3	Establish a service company within NJR as part of its reorganization. (Refer to Finding III-2).	20
5	Recommendation III-4	Terminate the links from the non-regulated entities' web pages to the utility (Refer to Finding III-3).	23
6	Recommendation IV-1	Establish procedures to ensure and document regulatory compliance for asset transfers, leases, or rentals. (Refer to Finding IV-1).	26
7	Recommendation V-1	Establish policies within NJNG and its affiliates to ensure that employee transfers are consistent with the Affiliate Standards. (Refer to Finding V-1).	29
8	Recommendation V-2	Develop a method of apportioning pension costs between affiliates for employees within NJR who transfer. (Refer to Finding V-2).	29
9	Recommendation VI-1	Develop a clearly written cost allocation manual incorporating these recommendations, distribute it to managers, and train managers to collect appropriate information to maintain it. (Refer to Finding VI-1).	57
10	Recommendation VI-2	Place greater emphasis on positive time reporting to improve cost assignment. (Refer to Finding VI-2).	57
11	Recommendation VI-3	Reduce dependence on a general allocation factor. (Refer to Finding VI-3).	58
12	Recommendation VI-4	Develop an indirect cost allocation model that allocates costs fairly between the utility and non-regulated affiliates. (Refer to Finding VI-4).	58

Recommendation Number		Recommendation Statement	Page
13	Recommendation VI-5	Ensure that the intercompany cost allocations audit scheduled for early 2001 gets completed in a timely manner. (Refer to Finding VI-5).	58
14	Recommendation VI-6	Institute changes in spreading of costs between NJNG utility and appliance repair operations. (Refer to Finding VI-6).	59
15	Recommendation VI-7	Correct deficiencies noted by Schumaker & Company in sampling of transactions and ensure that sufficient information is included in cost allocation manual to prevent these deficiencies from happening in future. (Refer to Finding VI-7).	59



II. Introduction

This report has been submitted in response to a request for proposal (RFP) from the New Jersey Board of Public Utilities (the Board or the Commission) for a consulting firm to conduct compliance audits of the competitive services of New Jersey Natural Gas Company (NJNG). The purpose of this audit was to ensure that New Jersey Natural Gas Company and/or its related competitive business segments do not have an unfair competitive advantage over other, non-affiliated purveyors of competitive services, and to evaluate and review the allocation of costs between New Jersey Natural Gas Company competitive and non-competitive services.

This report assessed whether there is strict separation and allocation of each utility's revenues, costs, assets, risks, and functions between the utility's gas distribution operations and its related competitive business segments. The audit also determined:

- (1) Whether cross-subsidization between utility and non-utility segments within a public utility or holding company exists;
- (2) Whether the separation of utility and non-utility organizations is reasonable based on the Board's affiliate relation and fair competition standards;
- (3) The effect on ratepayers of the use of utility assets in the provision of non-safety-related competitive services;
- (4) The effect on utility workers;
- (5) The effect of utility practices on the market for such services; and
- (6) Compliance with the *Affiliate Standards*.

The audit will provide the Board with the information necessary to determine whether the competitive services identified are in any way cross-subsidized by New Jersey Natural Gas Company's regulated activities and to determine the reasonableness of the lump-sum charges (i.e. service contract rates) and the time-and-materials charges encountered in a competitive environment.

The results of the audit will be used in conjunction with information gathered by staff in determining whether New Jersey Natural Gas Company is in compliance with the intent of NJSA 48:3-55, 48:3-56, and 48:3-58 to restructure New Jersey's gas industry to create open competition without undue consequences to the safety, adequacy, and propriety of traditional, basic utility service.

A. Synopsis of Audit

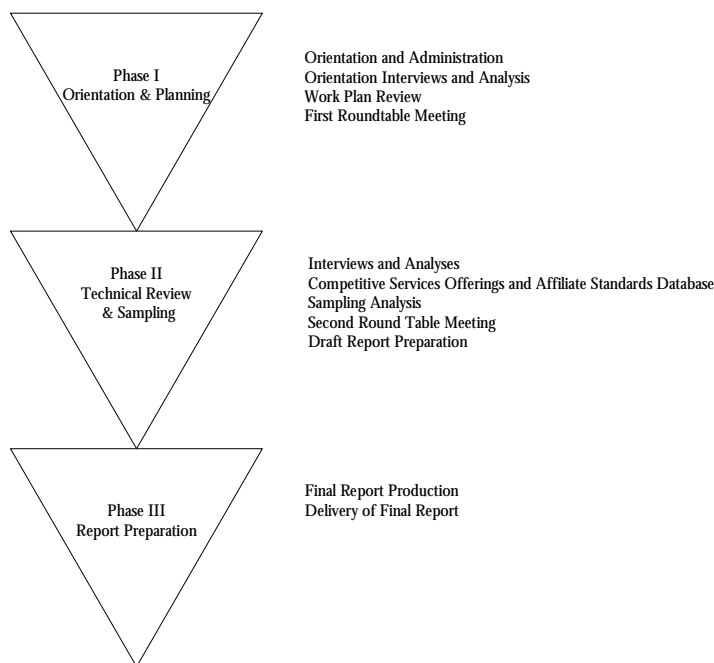
The State of New Jersey Board of Public Utilities (BPU) requires all gas public utilities to adhere to the requirements set forth by the BPU under the *Final Interim Affiliate Relations, Fair Competition and Accounting*

Standards and Related Reporting Requirements (Affiliate Standards) that was adopted by the Board in Order EX99030182 on March 15, 2000 in relation to the Electric Discount and Energy Competition Act of 1999, P.L. 1999, c.23.¹ Definitions in the *Affiliate Standards* that are most relevant to this report are:

- ◆ “Affiliate” is defined as a related competitive business segment of a gas public utility or a related competitive business segment of a public utility holding company.
- ◆ “Related competitive business segment of a public utility holding company” is defined as any business venture of a public utility holding company (not a utility), including, but not limited to, functionally separate business units, joint ventures, and partnerships and subsidiaries, that offers to provide competitive services.
- ◆ “Related competitive business segment of a gas public utility” is defined as any business venture of a gas public utility including, but not limited to, functionally separate business units, joint ventures, and partnerships, that offers to provide or provides competitive services.

This audit was conducted in three phases that are shown schematically in *Exhibit II-1*. These phases provided the Schumaker & Company audit team with a structured approach that is comprehensive and logical, as well as interactive and participative with the Board and the utility.

Exhibit II-1
Audit Approach



To assist our staff in these investigations, we developed a *Competitive Services Offerings and Affiliate Standards Database* to facilitate our investigations on this project. This tool is further described in *Chapter VII*.

B. Audit Team

Schumaker & Company's audit team for the Competitive Services Offerings and Affiliate Standards Compliance Audit of New Jersey Natural Gas Company consisted of the following individuals:

- ◆ Dennis J. Schumaker, Engagement Manager
- ◆ Patricia H. Schumaker, Lead Consultant
- ◆ Martin J. Murphy, Lead Consultant
- ◆ Karen K. Sikkenga, Consultant
- ◆ Hugo E. Romero, Consultant

¹ / RFP Attachment 3